

Message Text

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FOR UNDER SECRETARY ROBERS FROM SORENSEN

FOL REPEAT OTTAWA 4730 ACTION SECSTATE DTD 1 DEC.

QUOTE

LIMITED OFFICIAL USE OTTAWA 4730

E.O. 11652: N/A
TAGS: EFIN, CA
SUBJECT: SHARP DROP IN EXCHANGE RATE

REF: (A) OTTAWA 4688; (B) OTTAWA 4650

1. SUMMARY: IN LARGEST SINGLE-DAY DECLINE SINCE 1962, CANADIAN DOLLAR EXCHANGE RATE DROPPED 1.8 CANADIAN CENTS AGAINST U.S. DOLLAR ON NOVEMBER 29 AND CONTINUED SLIDE NOVEMBER 30. ANALYSTS CONTENT ONE OF MAJOR REASONS FOR DECREASE IN CANADIAN DOLLAR VALUE IS UNCERTAINTY GENERATED BY QUEBEC ELECTION RESULTS, BUT CANADIAN DOLLAR PROBABLY "OVER-VALUED" FOR MOST OF 1976 AS RESULT OF POORER ECONOMIC PERFORMANCE VISA-A-VIS U.S. ECONOMY. ONCE BANK OF CANADA LOWERED BANK RATE LAST WEEK AND INTEREST RATES BEGAN FALL, EXCHANGE VALUE STARTED DOWNWARD SLIDE AND CANADIAN DOLLAR CAME UNDER SELLING PRESSURE FROM VARIETY OF LIMITED OFFICIAL USE
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SOURCES. HEAVY BANK OF CANADA INTERVENTION (AN ESTIMATED C\$1 BILLION BOUGHT) FAILED STEM DROP BELOW PAR, AND PROBABLY SOME OF C\$1.3 BILLION SWAPPED DEPOSITS IN CHARTERED BANKS BEGAN TO BE CONVERTED. MOST ANALYSTS REFUSING MAKE PREDICTIONS

REGARDING BOTTOM OF CURRENT SLIDE, BUT SOME THINK CANADIAN DOLLAR AT ABOUT US\$0.97 WILL PREVAIL UNTIL FIRST OF YEAR AND THEN THERE WILL BE FURTHER DECLINE. LOWER EXCHANGE VALUE WILL HAVE ADVERSE EFFECT ON GOC ANTI-INFLATION PROGRAM, BUT CANADA'S COMPETITIVE EXPORT POSITION MAY BE IMPROVED. IT IS PROBABLY STILL TOO EARLY TO TELL WHAT EFFECT LOWERED EXCHANGE RATES WILL HAVE ON U.S./CANADIAN RELATIONS; HOWEVER, SOME POSITIVE GAINS MAY RESULT. END SUMMARY.

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2. CANADIAN DOLLAR EXCHANGE RATE DECREASED C\$0.018 AGAINST U.S. DOLLAR ON NOVEMBER 29 AND CLOSED AT C\$1.00 EQUALS US\$0.9709 ON INTER-BANK WHOLESALE MARKET. DROP WAS SHARPEST SINGLE-DAY DECLINE SINCE MAY 3, 1962, ACCORDING NEWSPAPER ACCOUNTS. DOLLAR CLOSED AT US\$0.9676 ON NOVEMBER 30.

3. LOCAL MEDIA AND WIRE SERVICE ACCOUNTS OF FALL IN EXCHANGE RATE CLAIMED THAT WORLD-WIDE SALES OF CANADIAN DOLLARS WERE RESPONSIBLE FOR MONDAY'S SHARP DECLINE. RECORD TRADING VOLUME TOOK PLACE IN CANADIAN CURRENCY MARKETS, AND SOME COMMENTATORS MAINTAINED THAT BANK OF CANADA HAD INTERVENED HEAVILY IN MARKET TO PREVENT EVEN SHARPER DECLINE. (ONE TV NEWSCASTER, QUOTING UNNAMED SOURCES, CLAIMED BANK HAS PURCHASED ABOUT C\$1 BILLION IN RECENT TRADING DAYS TO SUPPORT CANADIAN DOLLAR). DEPARTMENT OF FINANCE REPORT ON INTERNATIONAL RESERVES IN NOVEMBER DUE LATER THIS WEEK WILL GIVE BETTER INDICATION OF BANK'S INTERVENTION.

4. FINMIN MACDONALD, INTERVIEWED FOR TV NEWS, REFUSED GIVE INFORMATION ON BANK'S INTENTIONS OR PREDICT EXTENT OF CURRENT SLIDE IN EXCHANGE RATE. HOWEVER, MACDONALD STATED THAT CANADIAN DOLLAR HAD BEEN "OVER-VALUED" IN TERMS OF U.S. DOLLAR BECAUSE OF CANADA'S RELATIVELY POORER ECONOMIC PERFORMANCE THIS YEAR. BANK GOVERNOR BOUEY, MACDONALD SAID, WAS KEEPING HIM FULLY INFORMED ON SITUATION.

5. MOST COMMON REASON GIVEN FOR DECLINE IN EXCHANGE VALUE
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DURING RECENT DAYS BY VARIOUS BROKERAGE HOUSES, ECONOMIC COLUMNISTS, AND NEWSPAPER ACCOUNTS WAS "PSYCHOLOGICAL" REACTION OF INVESTORS, SPECULATORS AND MONEY MARKET MANAGERS TO QUEBEC ELECTION. RECENT SPATE OF STORIES ON "OVER-VALUED" CANADIAN DOLLAR (SEE REFTEL B) CONTRIBUTED TO ADVERSE PSYCHOLOGICAL REACTION.

6. OTHER FACTORS MENTIONED BY COMMENTATORS INCLUDED WOOD GUNDY REPORT OF NOVEMBER 25 THAT CANADIAN BORROWING ABROAD HAD SLACKENED IN RECENT WEEKS AND THAT THERE WERE "TRADITIONAL" SOUTHWARD FLOWS OF CAPITAL AT YEAR-END. GLOBE AND MAIL REPORTER ANGELA BARNES IN ARTICLE ON NOVEMBER 30 STATED "SOME EUROPEANS WITH

LONG-TERM PORTFOLIO INVESTMENTS ARE BELIEVED TO BE REDUCING THEIR EXPOSURE IN CANADA AND THEN SELLING THEIR CANADIAN DOLLARS."

7. A. E. AMES LTD., IN ITS MONEY MARKET BULLETIN OF NOVEMBER 26, STATED THAT "OTTAWA CANNOT HAVE THE DOLLAR RUN AWAY ON THE DOWNSIDE BECAUSE THIS WOULD HAVE AN UNWARRANTED IMPACT ON DOMESTIC INFLATION." HOWEVER, BULLETIN CLAIMED THAT "FURTHER WEAKENING OF THE DOLLAR WOULD NOT COME AMISS AS (THIS) WOULD AFFORD SOME SHELTER TO INDUSTRIES BESET BY IMPORT COMPETITION." END UNCLASSIFIED.

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8. EMBOFF HAS DISCUSSED SHARP DECLINE IN EXCHANGE RATES WITH JAMES DINGLE, ASSISTANT CHIEF OF INTERNATIONAL DIVISION OF BANK OF CANADA, WHO SAID THAT BANK WAS STILL HOLDING TO ITS PROJECTIONS OF PARITY FOR CANADIAN DOLLAR WITH U.S. COUNTERPART OVER NEXT FEW MONTHS. HE MAINTAINED THAT SHARP DROP IN VALUE WAS SHORT-TERM SITUATION BROUGHT ABOUT BY UNCERTAINTIES OVER QUEBEC ELECTIONS AND BAD PRESS ON CANADIAN ECONOMIC PERFORMANCE. UNDERLYING STRENGTH OF CANADIAN ECONOMY WAS STILL THERE, DINGLE SAID, AND OVERSEAS BORROWING SHOULD PICK UP WITH DROP IN EXCHANGE VALUE.

9. COMMENT: AS CANADIAN DOLLAR BEGAN SLIDE TOWARDS PAR, WITH MORE NEWS ACCOUNTS APPEARING LAST WEEK ABOUT UNCERTAINTIES FOLLOWING QUEBEC ELECTIONS, MARKET PSYCHOLOGY OF WEAKNESS IN CANADIAN DOLLAR BEGAN DEVELOP AND FEED ON ITSELF. THUS, SLIDE BECAME MORE PRECIPITOUS AND PROBABLY SOME OF DEPOSITORS HAVING LIMITED OFFICIAL USE
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\$1.3 BILLION IN SWAPPED DEPOSITS IN CHARTERED BANKS BEGAN PULLING OUT THEIR FUNDS. CONTINUED REFERENCE BY ECONOMIC COLUMNISTS TO "OVER VALUED" CANADIAN DOLLAR HELPED CREATE "SELL NOW" PSYCHOLOGY.

10. ALTHOUGH SOME ANALYSTS SAID TUESDAY THAT DECLINE IN CANADIAN DOLLAR APPEARED TO HAVE "BOTTONED OUT" AT ABOUT C\$1.00 EQUAL U.S.\$0.97 SINCE DOLLAR REBOUNDED SOMEWHAT FROM ITS LOW FOR THE DAY, ADDITIONAL DROP OF ABOUT 1/2 CENT ON TUESDAY MAKES EMBASSY LEERY REGARDING MAKING PREDICTIONS FOR SHORT-TERM. (CHIEF ANALYST FROM MERRIL LYNCH IN TORONTO TOLD INVESTMENT SEMINAR IN OTTAWA THAT THEIR PREDICTION WAS US\$0.95 IN NEAR-TERM).

11. SOME NEWSPAPERS AND TV COMMENTATORS ARE PLAYING UP ADVERSE EFFECTS OF CANADIAN DOLLAR DECLINE ON CONSUMER PRICES, PARTICULARLY FOR FRESH FRUITS AND VEGETABLES DURING WINTER MONTHS WHEN CANADA IS HEAVILY DEPENDENT ON U.S. IMPORTS. RESULT WILL BE RISE IN CPI; THUS HELPING THWART GOC ANTI-INFLATION PROGRAM.

12. IT IS PROBABLY STILL TOO EARLY TO TELL WHAT EFFECTS LOWERED EXCHANGE RATE WILL HAVE ON U.S./CANADIAN RELATIONS UNTIL WE GET CLEARER INDICATION OF WHERE EXCHANGE RATE WILL SETTLE FOR PERIOD OF TIME. HOWEVER, WITH CANADIAN DOLLAR WELL BELOW PAR THERE COULD BE LESS PRESSURE FROM CANADIAN AUTOMOTIVE PARTS MANUFACTURERS, FOR EXAMPLE, TO HAVE AUTO PACT REVISIONS. ALSO, GOC MAY BECOME MORE SYMPATHETIC TO FOREIGN INVESTMENT FLOWS SINCE BORROWINGS ABROAD COULD BECOME MORE DIFFICULT WITH OVERSEAS UNCERTAINTIES ABOUT CANADIAN ECONOMY, AND CANADA NEEDS INFLOW OF FOREIGN FUNDS TO COVER ITS LARGE CURRENT ACCOUNT DEFICIT. REALIZATION THAT CANADIAN DOLLAR IS VULNERABLE TO OUTSIDE FORCES AND THAT CANADA'S CREDIT RATING MAY NOT BE AS STRONG AS BEFORE COULD MAKE GOC POLICY MAKERS EVEN MORE WILLING TO CONSULT WITH USG ON COMMON ECONOMIC PROBLEMS AND SEEK CLOSER COOPERATION ON TRADE AND INVESTMENT PROBLEMS. THUS, NEW OPPORTUNITIES FOR CONSTRUCTIVE DIALOGUE BETWEEN TWO COUNTRIES MAY EMERGE AS RESULT OF WEAKENING CANADIAN DOLLAR.

ENDERS

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